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MEMORANDUM

SUBJECT: The Italian Political and Economic Situation
on the Eve of President Leone's Visit to the
US

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THE ITALIAN POLITICAL AND ECONOMIC SITUATION
ON THE EVE OF PRESIDENT LEONE'S VISIT TO THE US

1. Italian political crises have been frequent, almost chronic, but Italy is heading into one in the near future which goes deeper than usual. At the same time the country is experiencing its most severe economic crisis of the postwar period.

2. The reconvening of parliament one day before President Leone's arrival in the US will formally open a new political season in Italy. During the last month Italian political leaders have fired the opening salvos of a debate that is likely to culminate in the fall of Prime Minister Rumor's government within six months.

3. This debate is taking place on at least three levels.

- The Christian Democratic Party, which has dominated Italian politics since the end of World War II, is caught up in an increasingly bitter internal feud over leadership and policies.
- The Christian Democrats are at odds with their coalition partners -- the Socialists in particular -- over a variety of domestic and foreign policy issues.
- The powerful Communist Party is exploiting this disarray to press its case for a "new relationship" with the governing parties.

Christian Democrats Divided

4. The Christian Democratic Party has always been an amalgam of factions across a broad political spectrum. Seldom, however, has the party been as openly divided as on the eve of President Leone's visit. Two recent political setbacks triggered this internal quarrel.

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5. In May, the Christian Democrats suffered a landslide defeat when 59 percent of the electorate repudiated the party's stand against legalized divorce in a nationwide referendum. Veteran Christian Democratic leader Amintore Fanfani, against the judgment of many senior party figures, conducted a vigorous anti-divorce campaign focused on the theme that a vote for divorce would be an endorsement of communism, since the Communist Party took a pro-divorce position.

6. The voters did not buy this argument for several reasons. Among them was the fact that all three of the Christian Democrats' coalition partners -- Socialists, Social Democrats, and Republicans -- had joined the Communists in stumping for legalized divorce. The neo-fascist Italian Social Movement was the only party that lined up with the Christian Democrats.

7. Christian Democratic leaders counted on the influence of their traditional ally -- the Catholic Church -- to sway voters against divorce. Large numbers of voters, however, appeared to ignore the admonitions of the Church. The net effect of the referendum was to convey the impression that the Christian Democrats and the Church were sorely out of step with popular sentiment.

8. In June, the Christian Democrats received another setback in the Sardinian regional election. The Christian Democrats paid the price there for five years of poor administration by a regional government in which the party held a near majority. The contest showed significant losses for the party compared to both the previous regional election (1969), and the last parliamentary race (1972).

9. These jolts have led many Christian Democrats to fear that their party is in danger of losing its dominant position in Italian politics. All elements of the party are concerned, but there are wide differences of opinion over what should be done to remedy the situation. The strongest push for change, so far, has come from members of the party's left-wing factions, about 30 percent of the party. In general, this element wants

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the party to accelerate the pace of social and economic change in response to the progressive implications of the pro-divorce vote and the dissatisfaction revealed in Sardinia. They also believe that the party needs to push younger leaders to the fore and start phasing out the older personalities who have shuffled in and out of Italy's 36 postwar governments.

10. Some Christian Democrats are also lobbying for closer relations with the Communist opposition. Although predominantly from the party's left, advocates of this view include some prominent figures such as Minister of Industry De Mita. De Mita and others believe that it is time to initiate at least limited collaboration with the Communists -- Italy's second largest party. They argue that the Communists have become more moderate over the years and that democracy would not be endangered if the Communists were brought into the mainstream of political life.

11. The party's left wing also is attacking party chief Fanfani as responsible for the decline in Christian Democratic fortunes. The challenge has not been effective so far, however, because Foreign Minister Moro -- the party's most influential left-of-center leader -- has not yet thrown his full weight behind the anti-Fanfani movement. Pressure to replace Fanfani is nevertheless continuing to build. A number of Christian Democratic stalwarts, including Moro and Defense Minister Andreotti, are jockeying for position and Fanfani probably will be eased out -- possibly into the prime minister's job -- before the important regional elections next June.

12. Fanfani's removal would not end Christian Democratic troubles. Another leader might be less inclined toward the frontal collisions that have characterized Fanfani's dealings with the coalition parties and the opposition, but this probably would not be enough. The Christian Democrats will also have to shed the image of inefficiency and corruption acquired during the long years that they have held a near monopoly on political power. At the same time, they will have to contend in the governing coalition with the increasingly confident and assertive Socialist Party.

Dissent Within the Coalition

13. The same events that left the Christian Democrats divided and despondent -- the divorce referendum and the Sardinian election -- had a tonic effect on the Socialists, Italy's third largest party. The Socialists, junior partners in the coalition for most of the last decade, saw in the large pro-divorce vote a mandate to press more insistently for long-sought social and economic legislation. As one of the principal winners in the Sardinian election, the Socialists view that contest as further evidence that the tide has begun to turn in their favor.

14. The Socialists concluded that they have little to lose by behaving more aggressively within the coalition. They are convinced that any political test, in the form of a government crisis or even early parliamentary elections, will yield further gains for the Socialists at the expense of the Christian Democrats.

15. The Socialists will be pressing this fall for what they call a "reasonable" program of social legislation.

- They will emphasize areas such as public health where they argue that the cost of delay would be as great as the cost of new programs.

- They will also push for measures designed to hold unemployment to a minimum; a rise in unemployment is one of the inevitable side-effects of the austerity program fought over last spring and finally passed in mid-August.

16. The Socialists will join the Christian Democratic left in agitating for some form of governmental collaboration with the Communists. Most Socialists fear being overshadowed by the Communists should the latter actually join the coalition, but they see advantages in limited Communist participation. The Socialists reason, for example, that their proposals would stand a better chance in parliament if an agreement could be worked out under which Communist votes could be included in

the coalition's majority. Such votes would offset those of conservatives within the coalition who have blocked Socialist initiatives.

17. Such an arrangement also is attractive to the socialists because it would force the Communists to share responsibility for unpopular governmental actions necessitated by Italy's precarious economic situation. The Socialists compete with the Communists for the support of organized labor; the Communists enjoy the advantage, however, that they are free to criticize governmental policies opposed by the unions.

18. Further evidence of the Socialists' new confidence is seen in the fact that they have recently broadened the area of contention within the coalition to include foreign policy -- specifically Italy's commitment to NATO. The Socialists have never been enthusiastic about NATO, but, since joining the government in 1963, they have generally been content to focus on domestic affairs.

19. Following Athens' announcement that it intends to withdraw from NATO's military organization, the Socialists were the first to insist that no more US forces should be accepted by Italy. This new Socialist posture means that the Italian government will find it increasingly difficult to broaden its role in the alliance. At a minimum, if the government sought to expand Italy's commitment to NATO, or to increase the US military presence, it would probably have to make concessions to the Socialists on domestic issues to have any chance of success.

20. The two smaller coalition parties -- the Social Democrats and Republicans -- also have well-established views. The Social Democrats are the most ardent anti-Communists in the coalition and they have hinted that they would prefer new general elections to any deal with the Communists. The Republicans have frequently pulled out of the coalition over economic policy disputes with the Socialists and they would not hesitate to do so again if the Socialists forced any significant changes in the austerity program. The Republicans, in fact, have already called for a "clarification" of the political situation this fall.

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Communist Bid

21. The Italian Communist Party hopes to exploit this situation to extend their influence in the making of national policy. Although the Communists hold the balance of power in three of Italy's twenty regional governments and a large number of municipal governments, they have not actually participated in the national government since 1947.

22. Communist leaders do not appear to be angling for immediate membership in the governing coalition. They recognize that the Italian public and even their own rank and file are not prepared for such a dramatic move. They are concerned that a quick move to power might result in civil disorders that would unravel the steady progress they have made in the past 25 years. For the moment, the Communists would be satisfied with a limited, but still important, concession, such as formalized consultations with the governing parties in parliament. This would fit in with the Communists' strategy of gradually "conditioning" the governing parties and the public to accept them as a legitimate party qualified to take a place in the national government.

23. In practical terms the Communists already have an informal voice in government policy. During the mid-August parliamentary debate on economic programs, for example, they proposed some amendments which attracted enough support from left-of-center elements in the coalition to secure their passage. The amendments did not significantly reduce the revenue that will be taken in by the government, but they did lighten the tax burden on low income groups at the expense of corporations and the more affluent.

24. A number of factors favor the prospect that the Communists will have more influence in the future. The growing difficulty of governing Italy with the old formulas has made discussion of Communist inclusion commonplace; several years ago it would not have been seriously considered. Italy's economic situation has

further increased the Communists' political leverage, because the cooperation of their allies in organized labor is essential to the country's recovery.

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26. For their part, the Italian Communists have embraced detente and have suggested that Italian membership in NATO is no longer an obstacle to their participation in the government, provided Rome does not broaden its commitment to the alliance.*

27. In the end, however, the Communists cannot achieve their goal without the acquiescence of the Christian Democrats. Despite indications that some prominent Christian Democrats, in the center as well as on the party left, are privately persuaded that they will have to come to terms with the Communists eventually. The official Christian Democratic response, however, continues to be negative. Leone is in the forefront of those Christian Democrats who remain opposed to collaboration with the Communists.

* There are some differences within the intelligence community over how adversely the Italian Communist Party's entry into the government might affect Italian foreign and defense policy, and what Communist strategy in this respect would be. The question is analyzed in NIE 24-1-74, "Prospects for and Consequences of Increased Communist Influence in Italian Politics," 18 July 1974.

The European Angle

28. Rome's partners in the European Community are alarmed at the prospect of prolonged economic and political instability in Italy. They realize that a further deterioration of the Italian economy would have adverse repercussions from which they themselves would not escape. Most West European leaders, moreover, are concerned over the possibility of increased Communist influence in Italy.

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30. The Italians, for their part, have always been among the most enthusiastic supporters of West European unification, consistently maintaining that there is no contradiction between that goal and close ties with the US. They are now hopeful that additional aid will be forthcoming under EC auspices. Rome, moreover, is sensitive to the desire of its partners that Italy help itself -- a factor that played an important role in the rapid passage of the economic stabilization program.

31. On occasion, however, the Italians have shown a willingness to bend Community rules when important national interests are at stake. This was the case in May when Rome restricted imports without even consulting its EC partners about alternatives more in line with the principle of unfettered intra-Community trade. This suggests that, if and when Italian political leaders face the question of Communist entry into the government, they may give weight to European Community views, even though these would probably not be controlling in the decision.

Mammoth Economic Problems

32. Italy's political crisis may or may not prove to be a critical turning point, but there is no question of the severity of the country's economic and financial ills. Inflation is the worst in recent Italian history and the highest in the EC. The balance-of-payments deficit in the first seven months of 1974 reached \$6.3 billion, the equivalent of 5 percent of GNP, and may climb as high as \$10 billion by year's end. Foreign exchange reserves are perilously low and private credit facilities virtually exhausted.

33. To cut the deficit and slow inflation, the government has been forced to adopt an austerity program that will worsen unemployment and sharply curtail economic growth. In addition to the \$2 billion loan just obtained from West Germany, Italy is angling for long-term assistance from other official sources. Despite these measures, financing the payments deficit over the next year or so poses a formidable problem for the Rumor government.

34. Thanks to a "truce" with labor and expansionary monetary and fiscal policies, Rome brought the Italian economy out of a long recession in 1973. Real GNP increased 5.4 percent, with growth concentrated in the second half of the year following the drop-off in strike activity. Growth slowed to about 2 percent in the first half of 1974, however, as investment and export growth declined. At the same time, inflation accelerated because of hefty wage increases, a rising budget deficit, and skyrocketing prices for oil and other primary commodities. The rate of increase hit about 50 percent for wholesale prices and 20 percent for consumer prices.

35. Buoyant domestic demand in 1973 and early 1974 stimulated imports, especially of capital equipment and quality consumer goods. Late in this period, a steep rise in prices for crude oil and other imports accelerated the deterioration in the trade balance. The deficit jumped from \$1.7 billion in the first half of 1973 to \$4.0 billion in the first half of 1974. Mounting capital outflows induced partly by domestic

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political uncertainties added to the payments problem. Because of the resulting rapid buildup in foreign debt, huge foreign exchange losses, and bad credit rating, Italy found itself on the verge of bankruptcy in international financial markets.

Shift to Austerity

36. Balance-of-payments difficulties have forced Rome to shift its priorities in recent months. Since early 1974, cutting the trade deficit and reducing inflation have become more important policy objectives than economic growth. Because of labor opposition and fear that the lira would decline to an unacceptable level, Rome decided against trying to improve the trade account by allowing the lira to depreciate through a "clean float." Instead, the government imposed controls on capital outflows and implemented a prior-import-deposit scheme designed to curb imports and reduce domestic liquidity. Rome has promised the IMF that it will lift its import deposit requirements by March 1975.

37. The government backed up these direct controls with a program of domestic austerity. The fiscal and monetary measures it adopted are the result of a political compromise. The Christian Democrats favored tougher measures to curb import demand and inflation, while the Socialists wished to avoid threats to employment and to social welfare spending. The measures are probably the most stringent now politically feasible in Italy and are certainly more comprehensive than those taken by any other West European country to deal with payments problems.

38. Initially, the main adjustment burden fell on monetary policy. The Bank of Italy imposed a 15 percent ceiling on growth of bank credit, allowed interest rates to rise sharply, and -- more recently -- curbed commercial bank borrowing from abroad. It also strictly limited support to the bond market, thereby drying up a traditional source of funds for special credit institutions. The money supply, narrowly defined, is still expected to expand about 18

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percent in the second half of this year and about 15 percent in the first half of next year. Credit will be tight, however, because growth will lag behind the rise in nominal income and government borrowing requirements will remain high.

38. Fiscal policy was tightened considerably in August, when the government's new austerity program was officially adopted after considerable amendment to appease the Socialists, Communists, and labor unions. The program is designed to increase fiscal receipts by about \$4.5 billion -- some 3 percent of GNP -- thus cutting into domestic demand appreciably. The fiscal package includes increases in some public service rates, in contributions to national health insurance schemes, in value-added taxes on luxury goods and some meats, and in corporate income tax rates. A one-time surcharge on personal incomes of over \$15,000 also was levied.

Impact of Austerity

39. The Rumor government's austerity program should ease pressures on the balance-of-payments over the next year or so, but it probably will also bring the economy to a virtual standstill. Restrictive fiscal and monetary policies will depress investment and private consumption; export growth is expected to barely offset this drop in domestic demand. As a result, we estimate that real output will grow by less than 1 percent through mid-1975. Unemployment will rise, hitting perhaps as high as 6 percent of the labor force.

40. The expected drop in domestic demand, together with past lira depreciation, should allow Italy to improve its trade account appreciably in the months ahead. Export volume probably will grow at an annual rate of 10 percent in the current half-year and at 7 percent or so in the first half of 1975. We expect import volume to decline at a 4 percent rate in the second half of 1974, because of the austerity program and the continuing impact of the prior-import-deposit scheme, and then to recover by only 1 percent or so in the next half-year. Improving terms of trade will

also help to reduce the six-month trade deficit to an estimated \$2.6 billion by the first half of 1975 -- a still troublesome level but considerably below the record hit in the first six months of this year.

41. Despite the government's shift to more restrictive policies, prices almost certainly will continue to increase rapidly during the next year. The increase in value-added taxes included in the austerity program will directly raise consumer prices in the short run. Inflation, in turn, will trigger automatic upward adjustments in wages and larger negotiated wage hikes. Manufacturers can be expected to pass the increase in labor and other production costs on to consumers rather than cut already depressed profits. As a result, prices probably will rise by somewhat more than 20 percent between mid-1974 and mid-1975.

42. It is possible that political pressures will force the government to relax its restrictive policies before the end of this year. The trade unions may yet balk at the higher taxes recently imposed, even though upper-income groups bear a larger share of the increased burden. They -- like private business -- will continue to press for a relaxation in credit restrictions to avoid increased unemployment. To keep labor peace, the government may be forced to accede to these pressures long before its price and balance-of-payments objectives are realized.

Borrowing Efforts

43. To cover the balance-of-payments deficit through July, Rome arranged for \$2.3 billion in Eurodollar loans, a \$1.9 billion short-term credit from the EC, and \$1.5 billion in short-term commercial bank loans from abroad. It also drew down net central bank assets by \$0.6 billion. More recently, it drew \$322 million on its IMF tranche and \$300 million on its stand-by credit. Rome has also received a \$315 million credit from the new IMF oil facility.

44. Because its poor credit rating virtually precludes borrowing in private financial markets, Rome is seeking foreign official assistance to cover the balance-of-payments deficit expected during the rest of this year -- possibly several billion dollars -- and in 1975. Thanks in part to its new austerity program, Rome recently succeeded in obtaining a \$2 billion loan from the West German Bundesbank. This loan, which Rome must back with about 600 tons of gold valued at a market-related price, will be renewable at six-month intervals for up to two years. Bonn also supported Italy's recent successful effort to gain a three-month extension on repayment of the \$1.9 billion in short-term credits that fell due this month. In the Schmidt government's view, Italy should be the primary -- if not the sole -- beneficiary should the EC agree to float a joint loan on the international market to assist member countries in payments difficulties.

45. Rome will still have to obtain additional loans, particularly if it hopes to avoid substantial lira depreciation. A political crisis this fall could increase pressure on the lira up to last spring's level, when the central bank paid out \$50 million daily in support. If so, Italy's current reserve resources -- excluding gold but including the German loan -- would last for only three or four months.